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TARP Baby: The Administration's Resolution Authority for Nonbank Financial Firms

By Peter J. Wallison

The Obama administration's proposal for a resolution authority to unwind large nonbank financial institutions is another example of its misplaced effort to expand the government's role in the economy. The plan's fundamental flaw is its failure to explain how this or any other government will distinguish in advance between companies whose failure would cause a systemic breakdown and those whose failure will cause only an economic disruption of some kind. Without a way to make this distinction, the resolution authority will simply become a permanent TARP (Troubled Asset Relief Program). Other conceptual flaws in the administration's plan are its effect in creating moral hazard, enhancing the competitive advantages of large nonbank financial firms, increasing the uncertainty faced by creditors of nonbank financial institutions, and adding yet another burden for the taxpayers. In the end, the existing bankruptcy system, which has done a far better job of resolving Lehman Brothers than the Fed has done with AIG, seems a superior policy choice to creating yet another government agency with wide-ranging but ill-defined powers.

One of the most remarkable things about Washington is the fact that poor performance by regulators is regularly rewarded with more funds and broader powers, both conferred by a grateful (and apparently forgetful) Congress. So, we see the Securities and Exchange Commission (SEC) receive more resources and staffing after failing to detect the accounting frauds in Enron and WorldCom and the same agency calling (without shame) for more staff and funding after failing to recognize that Bernard Madoff was running a Ponzi scheme; we have seen all the banking supervisors—the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve—obtain enhanced authority after the savings and loan debacle (when almost 1,600 banks also failed), and now being offered new authority by the Obama administration after failing to use the earlier powers to avert the near collapse of the banking system; and most remarkable of all, we watch in awe as the administration tries to make the Fed the regulator of

virtually the entire financial system even though the agency—the closest thing we have had to a systemic monitor—abjectly failed to detect the housing

Key points in this Outlook:

- The Obama administration's proposals for regulation of the financial system reveal a misplaced confidence in the efficacy of government regulation.
- The failure of a nonbank financial institution is highly unlikely to create a systemic breakdown, so there is no reason to create a special resolution authority to prevent such a failure.
- Without a way to distinguish a potential systemic breakdown from a simple disruption in the economy, a government-run mechanism for the "orderly resolution" of nonbank financial firms will inevitably become a permanent TARP.
- The bankruptcy system avoids many of the problems associated with creating a government resolution authority and is a superior way of dealing with failed or failing nonbank financial firms.

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bubble that ultimately caused the very kind of crisis the Fed is supposed to prevent in the future. I recently listened to a speech by Christina Romer, the chair of the administration's council of economic advisers, who argued with a straight face that giving this new authority to the Fed would assure "accountability." Orwell would have been envious.

The point here is that Washington cannot seem to think of any response to a crisis except to increase the power and reach of the government's regulatory system, despite compelling evidence that it consistently fails to protect the public or maintain the health of the financial system. Many studies, in addition, have shown that regulation adds costs, suppresses competition, and reduces innovation; indeed, in the many areas of the economy in which *deregulation* has occurred—air travel, telecommunications, trucking, and securities brokerage, to name a few—it has uniformly produced innovation and lowered costs. It is time to think of something new, but imagination is not Washington's strong point.

The reigning liberal faith in the efficacy of regulation and government control is nowhere more clearly exhibited than in the proposals of the Obama administration for the regulation of the financial system. A number of earlier *Outlooks* have addressed the deficiencies and simple wrong-headedness of the Obama proposals,¹ but one idea has not received the extensive consideration it warrants—the notion that we need a government-run mechanism for the "orderly resolution" of systemically significant nonbank financial firms when they fail.² Of all the Obama proposals for expanding government authority, this is the only one that seems now to have any real traction on Capitol Hill—probably because both the regulatory establishment and the big financial institutions can see benefits in it for them. The administration's argument—building on the aftermath of the Lehman Brothers bankruptcy—is that allowing a "systemically significant" nonbank financial institution to enter an ordinary bankruptcy proceeding will produce a "disorderly" collapse and thus contribute to a systemic breakdown. The proposal applies only to nonbank financial institutions because insured banks and other depository institutions are already covered by a resolution system run by the FDIC.

According to the administration, nonbank financial institutions that might be systemically important include bank holding companies, insurance companies, securities firms, finance companies, hedge funds, private equity firms,

and any other financial-related firm that might—because of its "size, leverage or interconnectedness"—cause a systemic breakdown if it fails. The fact that none of those terms has any definitive content is a tip-off that what we are talking about is unfettered discretion.

This *Outlook* argues that while the terms "systemic risk" or "systemic breakdown" can be defined in words, they cannot be used as an effective guide for policy action. We have no way of knowing when or under what circumstances the failure of a particular company will cause something as serious as a systemic breakdown—as distinguished from a simple disruption in the economy. Government officials' inability to forecast or predict the effect of a particular company's failure will mean that the government will take over or rescue from bankruptcy many companies that should be allowed to fail in the normal way. As the late Irving Kristol observed, "it is politically impossible for any state to cope with the bankruptcies associated with economic risk taking."³ Once the government takes responsibility for preventing systemic breakdowns, it will use that authority liberally to prevent mere economic disruption. The bailouts of General Motors and Chrysler make clear how this will work. Moreover, it will be impossible to tell, after the government resolution authority has acted, whether the particular failure would actually have caused a systemic breakdown, making Congress's ability to oversee the use of this new power wholly ineffective. The result will be to introduce moral hazard into the financial system, as creditors come to believe that large financial companies will be rescued; the advantage this will confer on large firms will be competitively significant, driving small firms out of markets in which they could formerly compete and weakening the financial system as inferior managements and business models are saved from extinction by government action—all ultimately paid for by the taxpayers.

In addition, a resolution system for *nonbank* financial institutions is unnecessary to prevent a systemic breakdown. Such an event occurs when the failure of one financial institution causes such large losses to others that they are unable to meet their own obligations, thus causing losses to cascade through the entire economy. Losses of this kind, however, can only be caused by the failure of a large commercial bank, which deprives other banks of the funds they were expecting to be paid, deprives businesses of access to their working capital or payroll funds, and deprives

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individuals of the funds they use for their daily needs. The losses that occur when a nonbank financial institution fails are not of this character; they occur over time as obligations that come due are not paid and affect creditors and counterparties that are generally diversified and able to withstand an occasional loss. For example, a bank failure could deprive a business of the cash with which to meet its payroll, but it is highly unlikely that the failure of a nonbank financial institution will have a similar effect on the diversified lenders that are likely to be its counterparties.

Accordingly, there is no sound policy basis for providing the government with authority to resolve nonbank financial institutions, and granting such authority would be harmful to the financial system and the economy generally. Instead, failing nonbank financial institutions, both large and small, should be allowed to go into bankruptcy. This *Outlook* will show that the administration's proposal is both unnecessary and potentially harmful to the future stability of the financial system.

The Administration's Plan Compared to Bankruptcy

The administration's plan includes two possible scenarios—a conservatorship, in which the institution is managed back to viability, and a receivership, in which the institution is probably sold or liquidated. A conservatorship resembles a chapter eleven bankruptcy proceeding, in which the debtor remains in possession of its assets and continues to operate the business. In both cases, the objective is to return the firm to viability rather than to unwind it. However, in a government-mandated conservatorship, the firm is managed by a government agency, while in chapter eleven the operations of the company remain in the hands of its management. A receivership resembles a chapter seven bankruptcy, in which the debtor is simply wound up—its assets sold and creditors paid off based on their priority.

There are two requirements for a successful exit from chapter eleven—the necessary financing (known as debtor-in-possession, or DIP financing) to keep the debtor operating as a going concern, and the creditors' agreement to take less than they would get in a liquidation, in the hope that the debtor will eventually be able to pay them in full. In chapter eleven, the debtor prepares a plan for recovery, for approval by the creditors voting by class. If the creditors decide the company's prospects for eventual profitability are not sufficiently good to give them a chance to recoup their losses, they can vote down a plan for recovery, and the debtor will be liquidated.

Similarly, under the administration's plan, if the resolution agency (acting as a conservator) determines that there is no further danger of a systemic breakdown, it can liquidate the company—perhaps reimbursing itself for the funds it has extended—or return the company to financial viability if that is feasible and warranted by the circumstances. The administration's plan would, under most circumstances, assign the responsibility for resolving a failing financial firm to the FDIC and is thus another example of rewarding an agency whose performance has not been exemplary. In the last two years, the FDIC has resolved approximately 124 failing financial institutions. It does this under rules established in the FDIC Improvement Act of 1991, which empowered the agency to take over failing banks before they become insolvent. The purpose of this authority—called “prompt corrective action” (PCA)—was added to the FDIC's bank resolution arsenal so the agency could better protect the deposit insurance fund from the losses that occur when a failing bank's liabilities exceed the value of its assets. Nevertheless, the agency is seldom able to do so. The FDIC's average loss on the assets of the banks it has closed over the last two years is approximately 25 percent.⁴ If this is the record with respect to banks, it is fanciful to believe that the losses will be less for the much more complex and substantially larger nonbank financial institutions that the administration expects the FDIC to resolve—with no special expertise in the matter—in the future.

What Will Occur under the Administration's Plan?

Taking the administration's proposal at face value, an “orderly” resolution will begin as something like a conservatorship. This seems essential because—under the administration's assumptions—the failure of a systemically important company will, by definition, cause a systemic breakdown. In order to avoid that result, the company will have to be kept in operation for a period of time. Assuming that the necessary financing is provided by the government (an issue discussed later), the failed financial institution will be operated by the conservator, at least for a period of time necessary to assure there is no systemic breakdown when the institution is eventually closed. Under these circumstances, there are three possible outcomes for the failed institution's creditors.

Option One. If the objective of the orderly resolution is to avoid a systemic breakdown, then all creditors whose loans

mature when the government controls the institution will likely be paid in full. This is because the establishment of a conservatorship for the failing company is likely to be an event of default under its loan arrangements, which normally accelerates the maturity of its obligations. It is unlikely that the FDIC or any other government agency that takes over a nonbank financial institution will immediately stop payments to these creditors. This could—under the rationale for establishing a resolution agency—cause the systemic breakdown that the entire resolution structure is supposed to prevent.

Option Two. Another possibility is that the institution's long-term creditors are paid a portion of what they are owed but advised that they will not be paid in full at the end of the government's control. This would presumably prevent the immediate losses that would occur if payments to creditors were stopped entirely. This option would not be available in bankruptcy, in which prebankruptcy creditors can be paid only in special circumstances.

Option Three. A third option might be to stop all payments to creditors. This would be closest to a bankruptcy, where the debtor in possession is not generally able to pay prebankruptcy creditors unless there is an exemption from the stay provisions that normally apply. However, this is highly unlikely, since it would vitiate the entire rationale for setting up a government agency to resolve a failing nonbank financial firm. For this reason, in the following discussion, we will assume that the administration's plan will involve the use of either option one or two.

Is a Resolution Authority Necessary?

What is the problem for which a resolution authority is the solution? The administration's argument is that the collapse of a large nonbank financial institution could cause a systemic breakdown; to avoid this outcome, the government should have the authority to take over any such firm and resolve it in an orderly manner. However, the administration's rationale for its proposal is highly questionable.

Systemic Breakdown versus Economic Disruption. Is it possible to know in advance whether the failure of a particular firm will cause a systemic breakdown, rather than

simply an economic disruption of some kind? The failure of any large company will cause disruption—loss of jobs, losses to creditors, or perhaps the disappearance of an important intermediary. Although setting up a resolution system that would actually prevent a systemic breakdown might make sense, it would not be good policy to authorize

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a resolution system that, in practice, is used to prevent mere disruption. That would create extensive moral hazard and have the effect of preserving companies and managements that should be eliminated. If weak business models and bad managements are preserved by government action, that would weaken our economic system overall by preventing better business models and better managements from moving up to take their place.

The administration has not suggested how a systemic risk would be distinguished from a mere risk of economic disruption, and it is far from clear that it is possible to make such a determination in advance. Yet the distinction between the two is crucial; it provides the only limitation on the govern-

ment's power to take over failing financial institutions. Without such limits, it is highly likely that the power will be used to prevent ordinary economic disruption rather than the far more dangerous systemic breakdown. The recent rescues of General Motors and Chrysler are examples of government action to prevent economic disruption; no one has contended that the failure of either company, or both, would have created a systemic breakdown. Without clear limits, the resolution authority the administration is proposing will inevitably become a permanent TARP for the financial system.

What Causes a Systemic Breakdown? In advancing its various proposals, the administration has gotten a free pass on the question of what a systemic risk actually is and how a systemic breakdown might occur. Administration spokespersons regularly describe systemically important firms as those that are the "largest, most leveraged and most interconnected"⁵ but never say how these factors might create systemic risk. Even assuming that the administration could describe how it would distinguish between a systemic breakdown and an economic disruption, it still would be necessary to explain how a nonbank financial firm would cause a systemic breakdown if it were to fail.

Pointing to the events that occurred after Lehman's collapse a year ago is not sufficient. Although many observers seem to assume that what followed the bankruptcy of Lehman was a systemic breakdown, this is far from clear. The term systemic risk usually refers to the possibility that the failure of a single large firm will cause the failure of others through a contagion-like process in which a cascade of losses flows through an economy. The administration's concern about systemically important firms seems based on this idea since the Treasury proposes to regulate all large firms as a way of preventing systemic risk. However, applying this standard, Lehman's bankruptcy did not seem to cause major or systemic losses. With the single exception of the Reserve Fund—a money market mutual fund that had invested heavily and imprudently in Lehman's commercial paper—no such Lehman-caused failures have been reported. In a market in which there was none of the panic that existed in September 2008, Lehman's failure would not have caused a freeze-up that many have identified as a systemic breakdown. It is noteworthy in this connection that when the large securities firm Drexel Burnham Lambert failed in 1990, there was no major adverse effect on the markets, even though Drexel Burnham was as significant a firm at that time as Lehman was eighteen years later.

What happened after Lehman is better described as the result of a "common shock" to the market rather than a systemic breakdown. A common shock can occur as a result of any major event that creates widespread uncertainty about the future. Lehman was such a shock, largely because of the moral hazard created by the rescue of Bear Stearns six months earlier. After the Bear rescue, market participants were justified in believing that any firm larger than Bear would also be saved from bankruptcy. When that did not occur in Lehman's case, all market participants had to recalibrate the risks they faced in dealing with others, and the hoarding of cash began. Under this analysis, what followed Lehman's bankruptcy could have been provoked by the assassination of an important world leader, the collapse of the government of a major oil exporting country, or an earthquake in a major developed country. A common shock caused by any of these events would, of course, not be prevented either by regulating systemically important companies or setting up a special government authority to resolve them when they fail. For

example, as Stanford University economist John B. Taylor's analysis has shown,⁶ the global freeze-up in lending occurred several days *after* the Lehman failure, and was actually coincident with the Treasury-Fed request for what ultimately became TARP funds; it appears that there was a collapse of market confidence when the U.S. government appeared to be panicking, rather than a fear in the market that Lehman's collapse would cause losses to cascade through the world's economy.

If a systemic breakdown is the result of losses others actually incur because of the failure of a large nonbank financial institution, then the administration should explain the mechanism by which this contagion or cascading series of losses actually occurs. Indeed, it is not clear that there is a mechanism through which the failure of a nonbank financial institution—say, a bank

holding company—would be able to transmit losses to other institutions. It is easy to see how such losses could be caused by the failure of a large depository institution such as a commercial bank. Bank borrowings—deposits—are withdrawable on demand. Businesses deposit payrolls in banks, individuals use bank accounts to pay their daily obligations, small banks deposit funds in large banks and rely on large banks for access to the payment system. If a large bank fails, all these parties and many others suffer immediate cash losses and may be unable to meet their obligations, creating an expanding series of defaults through an economy. This is the classic systemic breakdown and why the FDIC has the power to step in and resolve a large commercial bank immediately.

Nonbank financial firms borrow for long and short terms, however, and their short-term borrowings are usually collateralized through repurchase (repo) agreements or asset-backed commercial paper. Both long- and short-term creditors of nonbank financial institutions are generally diversified and can take the eventual losses without becoming insolvent or illiquid themselves. In addition, the short-term or repo creditors have collateral that should enable them to recoup at least a substantial portion of their losses. Some observers argue that repo financing used by nonbank financial institutions can create conditions very similar to a bank run.⁷ However, these discussions generally do not explain what is systemically harmful about a run of this kind on a nonbank financial institution. Repo lenders are very different from depositors; in addition to the collateral they hold, they are much more likely to be

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diversified and thus less affected by the failure of a non-bank financial institution to which they have lent funds. In other words, although a “run” on a nonbank financial institution has similarities to a run on a bank, it does not have—it probably cannot have—the same systemic effects as a depositors’ run that causes a large depository institution like a commercial bank to close.

Thus, one can make a strong argument that systemic risk or a systemic breakdown cannot be created by the failure of a *non-bank* financial institution, and if so, there is no reason to create a special resolution authority to prevent the failure of such an institution. The same reasoning also nullifies the argument that a resolution authority would be more flexible in treating prebankruptcy creditors (option two above), since these creditors—which are largely diversified institutional lenders who would not be severely affected by the failure of large nonbank financial institution—do not need special treatment in order to avoid a systemic breakdown.

Additional Dangers From a Resolution Authority

Even if we concede that the failure of a nonbank financial institution *could* create systemic risk, there are still several reasons a government resolution agency for nonbank financial institutions would be bad policy.

Excessive Use. The existence of authority to take over a nonbank financial institution will make such takeovers more likely. As discussed above, once the authority is institutionalized through legislation, officials will use it to prevent disruptions in the economy, not just a systemic breakdown. Regulators will fear being criticized for the disruption that the failure of a large nonbank financial institution will cause—unemployment, a decline in stock prices, the temporary dislocations that occur to some counterparties or customers—but will be congratulated and treated as heroes if they step in to prevent these events. This is especially likely to occur because, as noted above, there is no effective way to distinguish in advance between a failure that will cause a systemic breakdown and one that will merely cause a temporary economic disruption.

Another important factor to consider is the ability of large companies and their managements to influence the government, and the ability of influential constituencies and powerful lawmakers to force government into granting

special benefits and dispensations. This cannot be underestimated. There will be pressure on regulators to rescue firms with influential managements, or from states or districts that are represented by influential lawmakers. If the resolution authority exists, it will be used to favor these companies, to the detriment of others, and probably the taxpayers.

Finally, as noted above, rescue of a firm that should otherwise have failed hurts the firms with better business models and better managements that might have moved up to take the place of the failed firm. Even in the unlikely event that a rescued firm is eventually liquidated, rather than simply returned to health under government control, the time between the takeover by the government, the introduction of government funds to keep the company operating and competing, and the prospect that the firm might one day return as a competitor will suppress competition from other, better-managed firms in the same market.

Moral Hazard and Competitive Advantages for Large Companies. The frequent use of the resolution authority will create moral hazard. A strong case can be made that the rescue of Bear Stearns did just this. After the Bear rescue in March 2008, creditors apparently expected firms larger than Bear to be saved. When Lehman was allowed to fail, this expectation was shattered, causing every market participant to reassess the safety and soundness of its counterparties.

So the danger is that as the resolution authority is used more frequently to prevent economic or financial disruptions, it will tend to create similar expectations for more and more firms, resulting in more moral hazard—and maybe even common shocks on a global scale—any time the authority is *not* used. The more moral hazard is introduced into the system, the greater the competitive advantage it will provide to the larger companies that will be eligible for resolution. This is because the potential of government support to prevent failure will encourage their creditors to believe they are less risky than other companies, weakening the usual restraints of market discipline. These apparently protected companies will be able to attract more capital and credit than their smaller competitors, which will gradually be forced out of contested markets.

Cost. As outlined above, the administration’s concept of an “orderly” resolution must involve placing a failed or failing institution in a kind of conservatorship so that it continues operating. Otherwise, abruptly closing it down

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will cause what the resolution authority was supposed to prevent—a systemic breakdown. Accordingly, the agency in charge of the conservatorship will have to provide the necessary funding so the company can continue to operate under government control. This will entail paying off its creditors in whole or in part and retaining its employees and necessary offices and equipment. All of this will require the expenditure of taxpayer funds, unless there is another funding source. The FDIC administers a fund maintained by deposit insurance levies on all insured banks and uses that fund to finance the closing of failed banks and the compensation of the insured depositors. It then reimburses itself by selling off the assets of the failed institution. Any remaining funds are used to pay off the uninsured depositors and other creditors.

Where will the funds come from for the resolution of nonbank financial institutions? One source might be the industry in which the failed company operated while another might be all large nonbank financial institutions. In either case, it would be difficult to set up a fund similar to the bank insurance fund, because the amount necessary for a credible fund would be very high.

The total government contribution to AIG exceeds \$100 billion at this point. This is considerably more than the FDIC's bank insurance fund which was \$52.4 billion at its highest point in 2007.⁸ To collect a sum this large in advance or to recover it afterward would require a serious levy on the companies called upon to make the contribution, perhaps jeopardizing their health but certainly jeopardizing their ability to compete outside the United States with foreign companies not subject to such a cost. The likelihood, then, is that—if a resolution agency is established—the taxpayers will ultimately end up footing the bill.

Lack of Expertise. The administration does not propose to establish a new agency for resolving nonbank financial institutions, but rather to turn over the resolution responsibility to the FDIC. This is problematic: resolving a bank is nothing like resolving a failed nonbank financial institution. For one thing, most banks are small and are resolved over a weekend. There is almost always a buyer for the deposits, and unless the bank is so large as to create a danger of a systemic effect, the only creditors the FDIC has to be concerned about are the insured depositors; these are often made whole simply by transferring the deposits to

a healthy institution. However, the institutions that will be covered by the administration's proposed resolution authority will be very large and complex. Because the objective of the resolution authority will be to make sure the failed institution does not cause a systemic breakdown (assuming it can), the resolution authority will have to be concerned about all its creditors, not just depositors. The FDIC will have no more experience in rescuing a large and complex nonbank financial institution than any other

agency. If we want an example of what that will be like, AIG provides it. That takeover has resulted in a huge transfer of government funds to AIG with no end yet in sight. AIG's once-healthy subsidiaries have not yet been sold to reimburse the taxpayers, and the final status of AIG is not yet resolved—a year after it was taken over.

When Bankruptcy is a Better Foundation.

The absence of any expertise in resolving failed nonbank financial institutions anywhere in the federal government is one strong reason for relying on bankruptcy for most failures. If there is likely to be expertise anywhere in resolving failed financial institutions, it would be in the

bankruptcy courts. Bankruptcy judges are appointed for terms of fourteen years and develop expertise in all aspects of insolvency and workouts. In large cities, bankruptcy judges, magistrates, and special masters are likely to have acquired the specialized knowledge necessary to resolve financial institutions—certainly more knowledge than government officials who have never seen an insolvent securities firm, insurance company, finance company or hedge fund. Any deficiencies in the bankruptcy system for handling large nonbank financial institutions are beyond the scope of this *Outlook*, but in any event can be addressed by legislation if these deficiencies are identified with specificity.

Bankruptcy as the first choice for disposing of a failed nonbank financial institution would avoid many of the problems associated with creating a government resolution authority. It would assure that the prebankruptcy creditors take losses of some kind—avoiding moral hazard and maintaining market discipline—and the rules are known in advance, so creditors will be aware of their rights as well as their risks. Both the Drexel Burnham bankruptcy in 1990 and the Lehman bankruptcy show that very large nonbank financial institutions can be resolved by the bankruptcy

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courts without difficulty. Indeed, the bankruptcy system has done a much more efficient job in resolving Lehman Brothers than the Fed has done with AIG. Within a few weeks of Lehman's filing, the trustee had sold off Lehman's broker-dealer, its investment management, and its investment banking business to four different buyers. None of this dispatch has been present in the AIG case. Finally, bankruptcy provides a market-based judgment on whether a firm should return to viability. The creditors ultimately decide whether they should forgo the partial repayment they will receive in a liquidation, in the hope that they will eventually receive full repayment if the debtor is returned to viability. When a firm is taken over by the government, however, political pressures—by important members of Congress or powerful constituencies—are more likely to be the determinants of whether the company survives. Again, General Motors and Chrysler are examples of this phenomenon. Sending failed nonbank financial institutions to the bankruptcy courts is the resolution mechanism embodied in HR 3310 (The Consumer Protection and Regulatory Enhancement Act), introduced in late July by the House Republican leadership. This seems a sensible alternative to the administration's plan.

Uncertainty and Unpredictability. Finally, the existence of a government resolution authority creates uncertainty about when it will be invoked and which creditors will be paid in what order. Although, as argued above, it is likely to be invoked more frequently than it should—that is, to prevent disruption rather than a real systemic breakdown—there will always be companies just on the other side of the “disruption line” that will not be rescued. The unpredictability about whether these borderline cases will be rescued will create moral hazard, arbitrary losses as well as arbitrary gains, and otherwise pervert the incentives of investors, counterparties, and creditors.

Other Special Cases

Bank Holding Companies. Although there is a procedure (through the FDIC) for working out failed banks, there is no such procedure for resolving bank holding companies (BHCs). There is no obvious reason why BHCs, which are companies that control banks, should be treated any differently than other nonbank financial institutions. All the points above about whether nonbank financial institutions can create a systemic breakdown apply to BHCs. Banking laws severely restrict transactions between banks and their holding companies, so that the failure of a holding com-

pany would not have any adverse effect on the condition of the bank and vice versa. There may be ways for holding companies to make it difficult for the FDIC to resolve failing banks (for example, the FDIC has found cases in which the failed bank had no employees—they were all employees of the BHC), but the FDIC has sufficient regulatory authority to address minor issues like this. They are not an argument for a special regulatory system for BHCs.

Ironically, the purpose of separating banks and BHCs has been to keep the “safety net” for banks from extending to the riskier activities of the holding company. Now, some in Congress and elsewhere who have always argued for keeping holding companies from engaging in commercial activities in order to “protect the safety net,” appear willing to spread the safety net to the financial activities of BHCs—such as securities and insurance—which are said to be riskier than banking and not appropriate for safety net coverage. The administration's proposal for a resolution authority and other proposals to allow the FDIC to take control of BHCs would now extend the safety net to BHCs, reversing many years of congressional policy, putting much more pressure on the deposit insurance fund, and raising doubt about the priority of BHC creditors. It is sometimes argued that BHCs should be treated differently from other financial institutions because they have an obligation to provide capital to their subsidiary banks, and if the holding company goes into bankruptcy, the FDIC will not have access to the capital that could be downstreamed to the bank. The idea that a BHC has an obligation to be a “source of strength” for a subsidiary bank is a Fed policy, not a law. It is one of those policies that the Fed uses to justify its continued authority to regulate and supervise BHCs. The Fed has asked Congress many times to enact this idea, and Congress has not done so. There is in fact no legal obligation for BHCs to support their subsidiary banks.

Complexity and International Operations. One other argument in support of a government resolution authority for nonbank financial institutions such as BHCs is that they are very complex and involve many different activities carried on all over the world. When such an institution fails, the many conflicts of laws and national interests make it difficult to unwind. That is certainly true, but the problem is not solved by turning it over to a government resolution authority. Resolving the many differences and conflicts among countries with jurisdiction over a failed financial institution is a task for diplomacy and intergovernmental organizations such as the International Monetary Fund and the Financial Stability Board. Whether the actual

resolution of a company is handled by a government agency like the FDIC or through an ordinary bankruptcy proceeding will not make these problems more or less tractable.

Conclusion

The enactment of the administration's proposal to establish a government resolution authority for certain large systemically important firms would be a major policy mistake. The administration has not shown how a nonbank financial institution could cause a systemic breakdown, and in the absence of such a showing, there is no reason to create a special resolution authority. Moreover, even if a nonbank financial firm could create systemic risk, the administration has not made clear how officials will be able to determine in advance whether a particular company will cause a systemic breakdown—rather than merely a temporary economic disruption—if it fails. In the absence of a standard for making such a determination, it is likely that the authority will be used frequently to rescue companies that might only create economic disruption if they fail. This will be especially true with respect to firms with politically powerful backers. Frequent and unnecessary rescues will introduce moral hazard and be costly to the taxpayers, who will end up paying the bills.

Under these circumstances, it would be better policy to use the existing bankruptcy system for failing nonbank financial companies. Not only is there no reason to rescue nonbank financial firms from bankruptcy, but sending them through the bankruptcy system also provides a degree of certainty to creditors that would not be available in a government run system, and the costs of a bankruptcy are borne by the failed company's creditors rather than the taxpayers. Most importantly, the bankruptcy system encourages creditors to monitor the companies they lend to, reducing moral hazard and enhancing market discipline.

Notes

1. See Peter J. Wallison, "Everything You Wanted to Know about Credit Default Swaps—but Were Never Told," *AEI Financial Services*

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